

## BEYOND PROHIBITIONS: UNVEILING THE HIDDEN DYNAMICS OF ISLAMIC ECONOMICS AND FINANCE

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### ABSTRACT

Despite theoretical differences between conventional and Islamic finance, critics argue that Islamic finance remains operationally similar to conventional finance. This apparent convergence in substance has led to growing disillusionment among stakeholders, prompting calls for a reassessment of the objectives and principles underlying Islamic finance. The objective of this study is twofold: first, to conduct a comprehensive comparative analysis between Islamic finance and conventional finance, and second, to explore the hidden dynamics of Islamic economics and finance by investigating its special theoretical features. By conducting intensive library research and reviewing main studies in Islamic economics and Finance, this study examines the salient features of Islamic economics and finance. The study identifies several hidden dynamics, including the role of money as a medium of exchange, prohibition of debt securitization, financing real sector development, the role of Islamic finance in infrastructure development, and the impact of Shariah screening mechanisms on stock market crashes. By examining the salient features of Islamic Economics and Finance, this research aims to provide theoretical insights that will contribute to academic literature, while also guiding regulators and industry practitioners in innovating financial products that more authentically embody the ethical spirit of Islamic finance.

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## I. INTRODUCTION

The prohibition of interest (*riba*), *gharar* and *maysir* are the most cited basic feature of Islamic finance. While conventional banking and finance is purely based on interest (borrowing and lending of the money), Islamic banking and finance is based on several Islamic contracts such as sale-based, partnership-based and services-based contracts (Siddiqui, 2006; Al-Jarhi, 2017). Islamic financial institutions in modern times develop products that connect all financial activities to genuine economic aspects and tangible assets. Islamic financial institutions employ contract types such as *mudarabah* (profit-sharing) and *musharakah* (joint ventures) to avoid interest-based lending thereby creating legal barriers requiring both profits and loss sharing from investors to entrepreneurs (Mirakhor & Zaidi, 2007). The risk-sharing implementation supports both economic stability and redirects funds towards productive areas to decrease unpredictable market volatility and speculative bubbles. Overall, the prohibition of *riba*, *gharar*, and *maysir* reflects a broader ethical and economic vision within Islamic finance. This vision emphasizes fairness, transparency, and accountability in all financial dealings, aiming to create an economic system where risk and reward are shared equitably and where financial activities contribute positively to social justice and sustainable development (Bhatti & Bhatti, 2010).

However, there is a general criticism towards Islamic finance stating that even though Islamic finance in its form is different from conventional finance, it is like conventional finance in substance (Azhar Rosly, 2010; Hanif, 2016; Hamour et al., 2019). Stated differently, even though Islamic finance is different from conventional finance in the contractual terms, it is like conventional finance from operational perspective. El-Gamal (2006) unveils the degree to which Islamic financial institutions have adopted *murabahah* and other contracts of sale that, in reality, are tantamount to interest-bearing loans. El-Gamal refers to this as “Shariah arbitrage,” where form is maintained but substance is conventional. Asutay (2012) also warns that the industry’s mania to substitute *riba* has fossilized into a new orthodoxy, stifling the original vision of profit-and-loss sharing and genuine partnership (El-Gamal, 2006; Asutay, 2012). Critics contend that changing contractual language does not eliminate the asymmetric risk exposures that caused the 2007–08 crisis. Mian & Sufi (2015) demonstrate how the preferential treatment of lenders in conventional mortgage amortizations accentuates system vulnerability. When Islamic banks simply replicate the same amortization schemes—even under “profit-sharing” titles—they entrench the very risk asymmetries that Islamic finance claims to eliminate (Mian & Sufi, 2015). Both systems employ loan amortizations in their housing loan or finance operations (Saiti, et al., 2016). Thus, it is time to rethink or evaluate the objectives or principles of Islamic finance beyond the prohibitions so that we can move towards the right direction. Otherwise, not only the Muslims are disenchanted with Islamic finance but also we will fail to show the hidden dynamics of Islamic economics and finance.

This study conducts a thorough comparative analysis between Islamic finance and conventional finance. Beyond the visible contractual differences, Islamic finance is built upon deeper socio-economic and ethical principles that aim to foster social justice, equitable wealth distribution, and genuine risk-sharing. This research seeks to uncover the “hidden dynamics” that drive Islamic economic

practices—dynamics that may not be immediately apparent when comparing surface-level contractual terms. The study investigates how the ethical imperatives of Islamic finance are intended to transform economic behavior by tying financial transactions to tangible assets and real economic activities, thereby promoting productive investment and discouraging speculative behavior. The Islamic finance moral requirements are not just to link financial transactions to real assets and real economic activity, but to creating cooperation, trust, and socially healthy relationships (Chapra, 2000; Iqbal & Mirakhor, 2011). Rather than promoting productive investment in a restricted capitalist sense of material expansion and profit maximization, Islamic finance is oriented towards ethically founded development for the general benefit (Siddiqi, 2006). In addition, the discouraging of speculation in Islamic finance specifically aims at *gharar*—excessive uncertainty and unjust enrichment—while being careful to recognize that future-directed investment such as innovation or searching for resources can be ethical when presented openly and in compliance with Islamic moral norms (El-Gamal, 2006; Kamali, 1996).

This research tackles the prevalent criticism that Islamic finance, despite its distinct contractual language, operates in a manner similar to conventional finance. For example, in order to reach its distinct ethical objectives, Islamic finance cannot rely on innovative contract vocabulary alone; it needs a robust institutional foundation. Zaman (2015) argues that genuine risk-sharing and asset-backed financing are based on three interdependent pillars: one unified Shariah regulating authority, harmonized regulatory frameworks across borders, and supportive legal frameworks enforcing Shariah rulings. Until these are in place, even formally Shariah-compliant products will revert to conventional lending in practice (Zaman, 2015). Addressing this gap is crucial for the credibility and development of the industry. By reevaluating the objectives of Islamic finance, the study aims to ensure that financial practices promote genuine risk-sharing, reduce exploitation, and support productive economic activity, thereby aligning financial outcomes with ethical principles. A deeper understanding of the divergence between form and substance in Islamic finance can help restore faith among Muslim stakeholders who feel disenchanting by current practices, ultimately strengthening the market. The insights from this study can guide regulators and industry practitioners in developing improved, more resilient financial products that better reflect the underlying ethical tenets of Islamic finance. The study also contributes to academic literature by identifying the hidden dynamics of Islamic economics and finance. Ultimately, the study aims to demonstrate how rethinking Islamic finance objectives can lead to a system that is not only compliant in form but also distinct in its operational outcomes, fulfilling its promise of promoting social justice and sustainable development.

This study is normative and theoretical in nature, drawing on reading of existing literature, theoretical synthesis of Islamic ethical principles, and normative argument testing existing finance paradigms. In putting the moral and socio-economic objectives inherent in Shariah first, the paper tries to outline how practice lags behind theory and to propose alternative pathways for genuine risk-sharing and asset-backed finance. The remaining of this paper is organized as follows: Section 2 overviews the basic principles of Islamic finance such as prohibition of

*riba*, *gahar* and *maysir* after this introduction section; Section 3 reviews and critically examines the proponents and opponents of Islamic finance; Section 4 identifies the hidden dynamics of Islamic Economics and finance (IEF) beyond prohibition and the concluding remarks, implications and limitations of the study are presented in the Section 5.

## II. THE BASIC PRINCIPLES OF ISLAMIC FINANCE

In this section, the prohibition elements of Islamic finance are discussed such as *riba*, *gharar*, and *maysir*.

### 2.1. Prohibition of Riba

The prohibition of *riba* is a fundamental principle in Islamic economics and finance, rooted in both the Qur'an and the Hadith. *Riba* is defined as any predetermined, fixed increase on a loan or in a trade, which goes beyond the actual value of the principal or goods exchanged. In classical Islamic jurisprudence, it is understood to mean interest or usurious practices. Scholars (Siddiqi, 1983; Chapra, 1992; Usmani, 2002) often distinguish between different forms of *riba*, such as *riba al-nasiah* (interest on loans) and *riba al-fadl* (excess in barter transactions). However, the core idea in all forms is that earning a guaranteed profit without sharing in risk or effort is unjust. The Shariah basis of *riba* is as follows:

- **Qur'anic Injunctions:** Several verses in the Qur'an explicitly condemn *riba*. For example, verses in Surah Al-Baqarah (2:275-279) make a clear distinction between trade, which is permissible, and *riba*, which is condemned as exploitative. The verses warn believers against engaging in *riba* and call for repentance from those who have transgressed.
- **Hadith Guidance:** Numerous Hadith further reinforce the prohibition by highlighting that *riba* is harmful to both individuals and society. The Prophetic traditions emphasize that engaging in *riba* is a serious sin, contributing to social injustice and economic imbalance.

#### 2.1.1. Rationale Behind the Prohibition

There are two reasons why *riba* has often been quoted as being prohibited: to safeguard equity and justice, and its broader economic and social consequences (Siddiqi, 2004). The former reason stresses safeguarding justice by preventing unjust enrichment. *Riba* allows one party to gain without assuming risk or contributing productive effort, thereby violating the moral principle of fairness. The second argument concerns the socioeconomic effects of interest-based finance, such as exploitation, wealth concentration, and systemic injustice. By eliminating *riba*, Islamic finance seeks to foster more equitable distribution of wealth and avert financial injustice. This is achieved through profit-and-loss sharing agreements—such as *musharakah* and *mudarabah*—whereby the interests of all stakeholders are harmonized through mutual risk and concerted effort. Zaman & Zaman (2001) take this argument further by contending that interest-based mechanisms produce structural imbalances, misaligned incentives, and financial instability. Their

criticism upholds the feasibility of equity-based schemes based not just on moral considerations but also because of their ability to produce more resilient and stable financial systems.

### 2.1.2. Implications in Modern Finance

Islamic finance institutions in modern times build their products with *riba* exclusion principles. Islamic financial institutions implement profit-sharing (*mudarabah*) and joint venture partnerships (*musharakah*) together with different risk-sharing contracts (Mirakhor & Zaidi, 2007). Both classical and modern scholars agree that *riba* stands forbidden but they debate the specific boundaries regarding contemporary financial instruments and global banking practices. The basic Islamic rule states that financial exchanges need to prevent exploitation between parties yet generate advantages for society as a whole. The Islamic stance on *Riba* consists of more than just forbidding interest due to its wider scope as an ethical and economic paradigm that bases financial operations on social equilibrium. The financial system which *riba* prohibition seeks to establish promotes transactions based on equitable reward sharing for all parties while aiming for justness and complete freedom from exploitation.

### 2.2. Prohibition of *Gharar*

*Gharar* prohibition stands as a core Muslim finance principle that ensures transparent and fair conditions to protect both parties in their contractual agreements. The concept of *Gharar* represents excessive uncertainty which literature (Kamali, 1999) classifies as ambiguous contractual conditions and risky elements. The concept goes past typical business risks because it includes uncertain factors which result in exploitative situations and unfair outcomes. The avoidance or intentional concealment of risks forming *gharar* leads to contractual disputes and financial losses according to Al-Suwailem (2012).

Though *gharar* is never mentioned in the Qur'an, Islamic custom strongly upholds openness and justice in contractual transactions. Islamic law, founded on hadith texts, demands the use of clear and unequivocal stipulations to ensure that no deception or injustice is practiced in businesses. Scholars such as El-Gamal (2001) and Al-Suwailem (2012) argue that the ban on *gharar* ensures that all parties to the contract have knowledge of the risks involved, hence contracting based on fairness and consensus. Three fundamental justifications underpin this prohibition: (1) elimination of contractual ambiguity that could be exploited by a party against the other, particularly where the latter is not entirely in command of information regarding the terms (El-Gamal, 2001); (2) enhancement of trust and reduction of risk through clear terms; and (3) development of an honest and equitable economic culture, as noted by Khan et al. (2019).

Besides, these ethical standards are justified in practical terms during banking crises such as the 2008 Global Financial Crisis. As Mian & Sufi (2015) describe in House of Debt, conventional mortgage structures enable lenders to transfer risk entirely to the borrowers, often those least able to bear it. This incentive imbalance—under which lenders benefit regardless of borrower stability—is a

significant cause of systemic collapse. On the other hand, Islamic finance, as based on equity-oriented forms like *musharakah*, facilitates risk-sharing and aligns all parties' interests, limiting moral hazard and systemic risk. Islamic prohibitions of *gharar* and excessive risk-transfer are therefore not only morally founded but also economically prudent in preventing instability and exploitation.

### 2.2.1. Implications in Modern Islamic Economics and Finance

Islamic financial institutions seek to build products with definite and clear terms in their modern economic and financial structure. 1) The cost-plus lending model (*murabaha*) and profit-sharing mechanisms (*mudarabah* and *musharakah*) serve to minimize uncertainty in Islamic finance sector. 2) Regulatory bodies for Islamic finance have established guidelines to prevent contracts from having elements of *gharar*, thereby protecting investors and ensuring fair dealing (Obaidullah, 2002). 3) Traditional finance allows some level of uncertainty or speculative risk to be endured or even welcome (such as with derivatives and other complex products) (Ayoub, 2014). In contrast, Islamic finance aims to eliminate uncertainty that could lead to injustice or exploitation (Kayed & Hassan, 2011). *Gharar* prohibition is one aspect of Islamic economic teaching that aims to render all contractual transactions free from excessive uncertainty and ambiguity. Not only does this protect the interest of all contracting parties but also promotes an ethical, transparent, and equitable financial culture.

### 2.3. Prohibition of *Maysir*

*Maysir* refers to any form of gambling or speculative venture through which profits are earned by chance rather than by productive effort or sharing of risk (Iqbal, 2005). It essentially refers to earning money without creating value, usually by engaging in games of chance or gambling. Although the term "*maysir*" is referred to less specifically than *riba*, the Qur'an clearly prohibits gambling and any activity with an element of it. Surah Al-Ma'idah verses 5:90-91 unequivocally ban intoxicants and gambling as abominations of Satanic work, intended to sow hatred and enmity among the faithful. The Hadith books also reinforce the prohibition by cautioning against games of chance and speculative endeavors that yield ill-gotten gains, underlining that such practices ruin moral and social commitments.

Similar to *gharar*, *maysir* also has several reasons why it is prohibited: 1) *Maysir* allows individuals to gain without investing in productive efforts or commensurate risk (Karim, 2010). This is unfair as it relies on chance alone and thus can lead to exploitation and economic imbalance. 2) Gambling and risk-taking behaviors instigate habits of dependence, resulting in social harm through the breakdown of domestic life, financial ruin, and social tension in general. By the exclusion of *maysir*, Islamic finance aims to evolve economic relations that are equal, transparent, and beneficial to society (Chowdhury, 2015). 3) Avoidance of *maysir* enforces investing and economic transactions with risk and reward common among equals (Iqbal, 2005). This helps in the creation of a strong financial framework rooted on durable assets and true economic engagement instead of speculation.

### 2.3.1. Implications in Modern Islamic Economics and Finance

Islamic financial institutions design products to avoid the characteristics of *maysir* through profit-and-loss sharing and asset-backed financing. This includes the use of frameworks like *mudarabah* (profit-sharing) and *musharakah* (joint venture), where both parties share the inherent risks and benefits. Modern Islamic finance stringently scrutinizes financial products to ensure that they do not include high levels of speculative features (Hassan & Lewis, 2007). Transactions are framed to limit uncertainty and avoid circumstances where success would depend merely on chance, bringing fiscal practices into conformity with moral values. *Maysir* prohibition signals an enhanced degree of dedication on the side of Islamic finance towards establishing an ethical, stable, and just economic order (Alhejaili, 2025). By excluding operations that derive profit solely on the basis of luck, Islamic finance promotes fairness, shared risk, and productive involvement, such that wealth creation is tied to true economic contribution and societal welfare.

## III. THE PROPONENTS AND OPPONENTS OF ISLAMIC ECONOMICS AND FINANCE

As a parallel financial system, Islamic finance and economy have proponents and detractors. The various perceptions of Islamic finance highlight the underlying controversy: proponents praise its ethical, equitable, and risk-sharing approach as building a more stable and equitable economic system, while detractors point to challenges in standardization, efficiency, and global competitiveness. With the industry continuing to grow, these debates drive ongoing research, innovation, and regulatory arguments to further refine Islamic financial practices in a bid to meet diversified economic conditions. The summary of the proponents of IEF is presented in Table 1.

**Table 1.**  
**A Summary of Proponents' Views on Islamic Economy and Finance**

| View of proponents          | Explanations  |
|-----------------------------|---|
| Moral and Ethical Standards | Islamic finance is built on strong ethical principles. It prohibits <i>riba</i> (interest), <i>gharar</i> (excessive uncertainty), and <i>maysir</i> (gambling), ensuring that financial transactions are conducted in a manner that avoids exploitation and promotes fairness (El-Gamal, 2006; Uddin, 2015). |
| Social Responsibility       | By encouraging profit-and-loss sharing and asset-backed transactions, Islamic finance aims to create a more equitable distribution of wealth. This risk-sharing mechanism is believed to contribute to social justice and reduce income disparities (Khan, 2013).   |
| Asset-Based Financing       | Islamic finance ties money to tangible assets and real economic activities. This is argued to mitigate the risks of speculative bubbles and reduce financial system volatility (El-Gamal, 2006).  |
| Shared Risk and Reward      | Financial products like <i>mudarabah</i> (profit-sharing) and <i>musharakah</i> (joint ventures) promote shared risk and hence foster a more resilient and sustainable economic environment (Alamad, 2024).   |

**Table 1.**  
**A Summary of Proponents' Views on Islamic Economy and Finance (Continued)**

| View of proponents             | Explanations  |
|--------------------------------|---|
| Catering to Ethical Investors  | For many Muslims, adhering to religious principles in financial matters is essential. Islamic finance offers a system where investments and financing comply with these beliefs, broadening financial inclusion (Demirguc-Kunt et al., 2014). |
| Innovation and Diversification | Islamic finance has spurred innovation in financial products and services, offering alternative avenues for investment and economic participation outside the conventional interest-based system (Iqbal & Mirakhor, 2011).                    |

Multiple concerns exist about Islamic finance from its critics. Experts' express concerns about the unclear nature of Shariah law and financial principles since they can be interpreted in multiple ways according to Azhar Rosly (2010) and Grassa & Gazdar (2014). Differing interpretations of principles under Islamic finance present risks that produce disparities between financial institutions at national levels and disunited operational practices by geographical areas. According to Ercanbrack (2019), critics maintain that most Shariah-compliant products are complex to understand and replicate conventional methods. Evaluators argue that these products display window dressing instead of following genuine Shariah principles (Karbhari et al., 2024).

Economically, Islamic financial products receive criticism because they reportedly have reduced market liquidity and higher costs than traditional financial alternatives (Ariff & Lewis, 2014). The emphasis on profit-and-loss sharing, they argue, can result in lower returns for investors and lower overall operating efficiency (Farooq, 2007). Besides, the Islamic finance industry remains comparatively petite in dimensions, and variability across jurisdictions in interpretation of regulations may slow its suitable incorporation within world financial markets (Mohamad & Kashi, 2017). Finally, on a regulatory as well as pragmatic ground, questions remain regarding whether inflexible adherence to religious provisions could stifle innovations and ability to adapt within ever-changing finance dynamics (Khan, 2013).

Critics are also worried about risk management in Islamic finance. Whereas risk-sharing is considered a virtue grounded in justice and fairness by proponents, critics argue that in application, these tools are unproductive and pose serious challenges, particularly during economic crisis (Khan, 2013). But a more trenchant argument—advanced by Zaman (2015)—is that the inefficiencies observed in Islamic finance are not inevitably an aftermath of the tenets of Islamic finance itself but a product of structural compatibility problems between the capitalist institutional environments in which Islamic financial ideals function and the ideals themselves. On this view, Islamic financial instruments are often used in regulatory, legal, and market circumstances that lack the supporting institutions—e.g., authentic governance patterns, value-based intermediation, and community surveillance—upon which efficacious true risk-sharing may be based. Alleged inefficiency on the part of Islam can therefore be a product of institutional misfit rather than failure in Islamic economic theory. This view is critical to the

explanation of limits touched upon in Table 2 and to guiding the design of more authentically Islamic financial institutions in the future.

**Table 2.**  
**A Summary of Opponents' Views on Islamic Economy and finance**

| View of Opponents                    | Explanations  |
|--------------------------------------|---|
| Interpretational Variability         | The principles of Shariah law as applied in finance are sometimes vague or open to differing interpretations. This can lead to inconsistencies across institutions and jurisdictions, making it difficult to establish standard practices (El-Gamal, 2006).         |
| Complex Structuring                  | Many Islamic financial products are complex and may replicate conventional financial products in substance, leading to accusations of "window dressing" rather than genuine Shariah compliance (Mansoor Khan & Ishaq Bhatti, 2008).                                 |
| Lower Liquidity and Higher Costs     | Islamic financial instruments are sometimes seen as less liquid and more costly than their conventional counterparts. The focus on profit-and-loss sharing might result in lower returns for investors and reduced operational efficiency (Iqbal & Mirakhor, 2011). |
| Limited Scale and Global Integration | Compared to conventional finance, the Islamic finance industry is relatively small. Its limited scale and diverse regulatory interpretations can hinder integration with global financial markets (Ernst & Young, 2016).  |
| Adaptability Issues                  | There is a concern that strict adherence to religious tenets might restrict innovation and adaptability in a rapidly evolving financial landscape (Kamla & Rammal, 2013).   |
| Risk Management Concerns             | While risk-sharing is a strength, in practice, it may lead to inefficiencies or challenges in risk management, particularly during economic downturns (Ahmed, 2011).  |

#### IV. THE HIDDEN DYNAMICS OF ISLAMIC ECONOMICS AND FINANCE

Before examining the hidden dynamics of IEF, it is important to understand some key differences between conventional and Islamic finance such as the difference between *riba* and rate of return, financing the real sector versus investing in toxic assets, predetermined interest rate versus predetermined profit-sharing ratio, debt system versus risk sharing system, among others.

**Riba versus Rate of return:** In Islamic finance, *riba* refers to a fixed, predetermined interest or usurious charge on a loan as we described above (Chapra, 1984). It is considered unjust because it guarantees a return to the lender irrespective of the actual performance or profit of the borrower, thereby transferring little or no risk (Omar Farooq, 2012). In conventional terms, the rate of return is the gain or profit made on an investment, which may be fixed or variable. In Islamic finance, however, the return is typically linked to the performance of the underlying asset or business. This means that instead of a guaranteed interest, returns are contingent on actual profits, ensuring a fairer risk-reward balance (Mirakhor & Zaidi, 2007).

**Financing the Real Sector vs. Investing in Toxic Assets:** Financing the real economy involves lending to activities that produce physical goods—e.g., manufacturing, agriculture, real estate, and infrastructure—and are, by nature, asset-backed and directly contributing to economic productivity and stability (Mujeri & Mujeri, 2020). Toxic assets, on the other hand, are high-risk financial

products—typically derivatives or securities backed by subprime or non-performing loans—that have no productive underlying assets and are prone to market risk and systemic risk (El-Gamal, 2006). Islamic finance avoids such instruments, which are inherently speculative and have no bearing on real economic activity (Ahmed, 2010).

There is, however, a further ethical consideration required. As noted by Saarim (2025) in the report “Halal Genocide,” Islamic investment on a large scale has been put into arms manufacturing and espionage equipment. While such industries may technically be Shariah compliant in theory, backed by assets and free of interest, they are seriously ethically compromised if they are linked to systemic injustice, repression, or militarism. This reveals a significant tension: not everything that is real-sector finance is morally benign. So Islamic finance must move beyond compliance checklists and truly reflect on the moral ends and social effects of its financing. Effective compliance with Islamic ethical principles requires that investment promote public good (*maslahah*) and never be involved in evil, albeit structurally compliant with the conditions of tangibility and collateral of assets.

**Predetermined Interest Rate vs. Predetermined Profit Sharing Ratio:** Under conventional financing, the interest rate is fixed in advance. The lender receives this set amount regardless of how well the borrower’s venture performs. This fixed repayment structure does not adjust to the actual business risk or outcomes (Usmani, 2021). Contrary to this, in Islamic financing models such as *mudarabah* or *musharakah*, the profit-sharing ratio is agreed upon before entering into a contract. Although the ratio is predetermined, the actual returns depend on the performance of the underlying business (Mirakhor & Zaidi, 2007). This means that if the business does not earn a profit, the investor’s return may be very low or even nil, ensuring that both profits and losses are shared between the parties.

**Debt System vs. Risk Sharing System:** Conventional finance predominantly operates on a debt system where funds are lent with an expectation of fixed repayments (interest and principal) irrespective of the borrower’s success (Shaikat & Alhabshi, 2015). In this system, the risk is largely borne by the borrower, and the lender’s return is guaranteed regardless of the underlying business performance. On the other hand, Islamic finance emphasizes a risk sharing approach. The risk-sharing models (e.g. *mudarabah* and *musharakah*) have several distinct features. Both the investor and the entrepreneur share in the profits and losses, which aligns their interests toward the success of the venture (Abdul-Rahman et al., 2014). Since returns are tied to actual outcomes, both parties are motivated to ensure the venture is managed well. This system is designed to foster fairness and social justice, avoiding the exploitative nature of fixed, interest-based lending (Chapra, 1985).

**The Importance of the Underlying Asset in Islamic Finance:** One of the core principles in Islamic finance is that every financial transaction must be tied to a tangible asset or real economic activity (El-Gamal, 2006). This requirement has several advantages: 1) The existence of an underlying asset makes the transaction more concrete and less speculative. 2) By linking finance to real assets, funds are used for productive purposes, which supports economic development and minimizes the likelihood of speculative bubbles. 3) Asset-backed financing ties risk to the actual performance of a physical asset or business activity, aligning the interests of both investors and entrepreneurs.

Each of these distinctions underscores the fundamental differences in the philosophy between conventional finance and Islamic finance, with the latter emphasizing ethical practices, tangible economic activity, and shared risk to promote a more balanced and just financial system.

#### **4.1. The Hidden Dynamic 1: The Role of Money in Both Conventional and Islamic Financial Systems**

Money, in conventional finance, is considered an asset that can be bought, sold, or traded to generate a return (Heinsohn & Steiger, 2002). Investors and financial institutions treat money as any other commodity, which can be traded. Money lent carries an extra predetermined interest, irrespective of the success of the borrower. This turns money into a device for earning interest rather than making transactions. When money serves as a commodity, people stack it up rather than spend it. This stashing leads to wealth concentration, which ultimately leads to imbalances and fuels economic instability (Hart, 2001). Focus shifts from promoting trade and real economic activity to earning returns through financial speculation and debt instruments.

Money in Islamic finance is predominantly considered a medium of exchanges (Usmani, 2021). It should not be used as an end in itself or a financial instrument that earns money. Instead, it is employed to finance real economic activity. Islamic finance promotes profit-and-loss sharing contracts rather than fixed interest (*riba*) (Ben Amar & El Alaoui, 2023). This means that all return on capital is attached to the actual performance of an asset or a business, and thus both sides incur the risks as well as the benefits. Mufti Mohammad Taqi Usmani explained at the World Economic Forum in 2010 how directing money from its intrinsic function—as a medium of exchange—into a subject of exchange has turned the economy into a debt and over-indebtedness balloon.

Islamic teachings promote the circulation of working capital to purchase commodities as it promotes economic development in all ways (Iqbal & Mirakhor, 2013). Payment through continuous economic activity allows greater enrichment of productive efforts while being fair in terms of wealth distribution in society. The idea of money as a tool of exchange between people guides financial institutions toward ethical investment as well as justice in society (Chapra, 1985). Speculative business activities are to some degree discouraged by this route because they have a tendency to create more than necessary debt that accumulates financial bubbles (Kirzner, 2009). These economic purposes provide useful industrial endeavors which minimize inequality and promote stable economic growth.

The use of an asset upon which lenders and owners of the asset can earn fixed incomes causes financial instability (Crockett, 1996). People understand money is accessible as a means of exchange that supports commerce and maintains actual economic activity. Islamic finance promotes profit-and-loss sharing practices and not fixed income thus leading to sustainable development with fair wealth distribution (Maghrebi & Mirakhor, 2015). The underlying philosophical shortfall underlies this basic distinction. Using either debt products or financial speculation, the conventional systems earn money differently from how Islamic finance uses the coming together of moral principles and actual economic inputs in financial operations.

#### **4.2. The Hidden Dynamic 2: The Limit of Debt Securitization in Islamic Finance**

Debt securitization is the process of taking various forms of contractual debt (e.g., mortgages, automobile loans, or credit card receivables) and packaging the debt as bonds or other securities for sale to investors (Tavakoli, 2004). It transforms illiquid debt into tradable securities, providing liquidity for lenders and new investment for investors.

Securitization of subprime mortgages in the United States is the primary source of the global financial crisis that began in August 2007 (Fligstein & Goldstein, 2010). Once housing prices began to drop, the assets underlying the securitized products lost their value, and there was a chain reaction in financial markets. It was the interconnectedness of securitized debt that allowed the crisis to spread from the United States to financial systems worldwide, leading to widespread instability.

In the conventional financial system, allowing widespread debt securitization makes the financial system more vulnerable to shocks, as the divorce of the debt from underlying real assets increases the likelihood of widespread defaults (Kara et al., 2016). The crisis showed that when debt is highly securitized, even localized problems (like a housing market bust) can cascade into global financial instability (Buchanan, 2017).

Securitization of debt is discouraged in Islamic economics and finance on the basis of several significant reasons: 1) The transactions should be connected to real, physical economic assets rather than financial instruments that are abstract. 2) Ethical and risk-sharing principles are prioritized in Islamic finance, which is undermined by selling debt as commodities. Saiti & Abdullah (2015) observe that there is not even a consensus (*ijma*) between jurists regarding the permissibility of the sale of debt to third parties. Sale of debt for profit would be similar to speculation and not actual trade in assets. Such activities would lead to misaligned incentives and excessive risk concentration, which are against the foundations of Islamic economics.

By limiting or discouraging securitization of debt in Islamic finance: 1) Financial transactions remain connected with real, tangible assets so that investment is for actual economic activities (Farooq & Selim, 2019). 2) Less trading of debt as a commodity avoids excessive leverage and speculative bubbles. 3) A more concrete system dependent on real assets is more resilient and less likely to suffer from cascading failure, making a crisis less likely (Farooq & Zaheer, 2015). 4) The Islamic system, in promoting profit-and-loss sharing and asset-based financing, makes possible a more secure system by its very nature (Ahmed, 2010). The system itself is structured with sustainable growth as a goal, avoiding weaknesses common in conventional systems supporting extensive securitization of debt.

In a nutshell, the excessive dependence of the traditional financial system on debt securitization is one of the key causes of the global financial crisis as it divorces debt from underlying assets and leads to excessive risk-taking and speculation. Islamic finance, in contrast, discourages securitization of debt due to its moral, risk-sharing, and asset-backed nature. By banning this activity, Islamic finance aims to build a more stable and resilient financial system that promotes real economic activity and minimizes systemic risk.

### **4.3. The Hidden Dynamic 3: Bridging the Gap: Financial Asset Growth and Real Sector Development**

The primary goal of conventional banks is to grow the financial assets while acting as financial intermediaries according to Allen & Santomero (2001). The economic split between real markets and financial markets leads to financial crises and systemic risk according to Acemoglu et al. (2015). Kahf (2007) leads proponents of Islamic finance advocating Islamic banks for increased development of the real sector. Through its economic framework, Islamic finance establishes a link between financial activities and productive production to reduce economic instability leading to sustainable growth (Iqbal & Mirakhor, 2013).

Conventional banks are conventionally regarded as financial middlemen—accepting deposits and lending them out to securities, derivatives, or loans (Greenbaum et al., 2019). More recent academic and central bank research challenges this middleman theory. As the Bank of England scholars McLeay, Radia, & Thomas (2014) would have it, modern banks create the money they lend through balance sheet expansion, rather than reallocated existing savings. This fact radically shifts our understanding of banking power and has extensive implications for Islamic finance. While conventional finance, driven by maximizing financial asset appreciation through leverage and securitization (Stulz, 2005), does create such endogenous money, Islamic finance, bounded by the necessity of real-asset backing, does not create such money.

This presents two essential challenges. First, the capitalist model of making money to make money provides room for unbounded money expansion for financial speculation, while Islamic approach would instead be centered on making money for social benefit and public service. Consistent with Zaman (2024), creating a truly Islamic monetary system involves the introduction of new paradigms and institutions which are focused more on empowering individuals than profit-oriented expansion. Second, expansion in shadow money—unregulated financial claims that act like money—via shadow banking has created a situation where the level of financial claims within the world system now reaches 200 times world GDP. If Islamic finance is not strategically tailored or shielded from being part of this, it can be relegated to the fringes of the global financial system—a “halal sheep” among financial wolves. This suggests an immediate necessity to examine defensive measures that restrict destabilizing capital flows into Islamic economies, like barriers to prevent haram funds from owning halal assets, and disengagement on selective bases with speculative global financial markets. This vision is at odds with the prevailing efforts to fit Islamic finance into mainstream approaches, and instead demands independent, ethically grounded institutions that are committed to social justice, economic stability, and systemic defense against high-risk financial structures.

Islamic banks, according to Kahf (2002), should move away from the status of being pure financial intermediaries. Rather than being interested only in the increase of financial assets, Islamic finance focuses on increasing the real sector (Smolo & Mirakhor, 2010). This comes from a variety of basic precepts: 1) Islamic finance places emphasis on financing being backed up by tangible assets (Ayub, 2009). By financing productive activities—e.g., production, agriculture, and infrastructure—Islamic banks ensure that their operations directly lead to

economic progress. 2) Instead of accumulating fixed returns in the form of interest, Islamic banking schemes encourage profit-and-loss sharing arrangements (Iqbal & Mirakhor, 2011). This aligns the bank's and the entrepreneur's interests so that gains are tied to the success of real economic activities rather than speculative financial games. 3) Islamic finance integrates moral factors into investment decisions (Bangash et al., 2019). Excluding speculation products and focusing on industries that are positive for society, Islamic banks ensure sustainable economic development.

By emphasizing growth in the real sector, Islamic banks can close the widening gap between the financial sector and the real economy (Kahf, 2002). Direct investment in productive sectors not only creates jobs and income but also results in a more balanced and stronger economic base. This integrated approach is aimed at minimizing the vulnerabilities of a system too reliant on financial asset growth.

The Islamic banking model based solely on financial asset expansion typically produces separation between real sector development and financial market operations which directly contributes to financial market failures. Kahf (2016) explains that Islamic finance generates a banking model which positively advances the development of the real economic sector according to his view. Through this practice Islamic banks can reduce the financial-real sector disconnection which enables enhanced economic stability and sustainable development. The reorganized banking system brings about an essential transformation in bank operations because they need to transition from facilitating transactions toward driving real economic growth.

#### **4.4. The Hidden Dynamic 4: The Financing of Development Infrastructure**

Financing infrastructure development has long remained a problem for developing economies due to the huge sum of initial capital required—often higher than these governments can provide (Uluyol et al., 2026). Conventional approaches typically take on debt-financed forms, which, while being affordable, expose the macroeconomy to risk through increased leverage and foreign currency exposure. Islamic finance offers an answer in the form of instruments like sukuk, which, according to Ismath Bacha & Mirakhor (2018), can be employed to finance public infrastructure with private capital while maintaining asset-backing and risk-sharing characteristics, thereby mitigating some of the interest-based debt's endemic systemic risks.

But beneath the financial framework is a deeper moral issue. With capitalist systems, infrastructure financing happens at the hands of investors seeking private returns—gathering wealth is the dominant impetus. Sukuk is a refinement insofar as it directs profit motivation to socially desirable purposes. But classical Islamic civilization is even more advanced: moral reward in the Hereafter is an efficient incentive for funding public goods. As emphasized in the hadith literature, acts done purely to bring fame or worldly gains do not receive reward in the Hereafter. This awareness in the past led to waqf—permanent, voluntary donation intended to lifelong learning, health services, and public facilities for God's sake. If modern Islamic finance can creatively re-create that value-based tradition, it could expand the choice of infrastructure financing beyond what has been thought up in capitalist

economies—grounding them solidly not only in economic savvy, but in spiritual accountability and social justice too.

Development infrastructure is at the very heart of economic development and societal advancement. Its funding, however, is a significant challenge in most developing countries. The infrastructure projects are inherently capital-intensive, and therefore require enormous, upfront sums of money (Walter, 2016). Though private sector firms can raise capital in a mix of debt and equity, governments only have access to debt finance since they lack the facility to issue equity. This institutional constraint not only restricts the sources of finance but also raises the dangers of too much public debt. There is a heavy initial capital outlay involved in infrastructure schemes, and governments therefore resort to external sources of finance (Merna & Njiru, 2002). There are two dominant channels that have developed: foreign borrowing and public-private partnerships. The governments can borrow as well from international financial institutions or overseas and private partnerships offer a different avenue. However, private partnerships tend to imply complex risk-sharing contracts.

Since governments are not allowed to issue equity, debt financing remains the most common method (Ismath Bacha & Mirakhor, 2018). However, the process has some important implications. First, borrowing increases the leverage of a country and if it become excessive, it would destabilize the fiscal framework (Jarmuzek & Rozenov, 2019). Second, high debt makes countries vulnerable to interest rate risks, contagion, and currency mismatches, particularly if borrowing is in foreign currency denominations (Alesina et al., 1992). And third, with rising interest rates, the cost of servicing outstanding debt increases, putting stress on the public finances (Blanchard, 2019). Combined, these factors help to emphasize little room left for additional debt funding, prompting calls for different sources of funding instantly. While being mindful of the debt-funding constraints, there is a growing need to explore funding instruments that do not exacerbate leverage. The Islamic finance sector has innovative tools that could help fill these issues:

As stated by Ismath Bacha & Mirakhor (2018), several Muslim countries are burdened by external debt due to lack of adequate domestic resources to use for financing development. Sukuk is a Shariah-compliant mechanism that is able to reduce the application of conventional debt. Through investment structuring in terms of asset-backed securities rather than conventional debt, sukuk has the capacity to mitigate economic uncertainty and lower the risk of vulnerability to exchange rates and commodity prices. These instruments not only offer a second channel for financing but also mitigate some of the dangers of too much external borrowing.

In summary, the long-term reliance on debt financing in emerging markets has profound consequences (Tran, 2022). The challenges of increasing leverage, macroeconomic instability, and exposure to external shocks are compounded by a world debt environment where additional opportunities for borrowing are limited (Heller, 2003). The rising interest rate environment further compounds these issues, as higher borrowing costs burden already stressed fiscal structures. To this end, research into non-leveraged financial products becomes an imperative. Islamic financial innovations, such as sukuk, present a plausible option to diversify sources of finance, which may have the effect of mitigating the macroeconomic pressures

of conventional debt (Uluyol, 2023). By reducing debt reliance and looking for new, non-leveraged sources of finance, developing economies can better manage fiscal risks and tap into the capital needed for critical infrastructure development.

#### 4.5. The Hidden Dynamic 5: The Role Shariah Screening Mechanisms in Stock Market

Stock market crashes in the past have created severe consequences for both emerging and developed economies. Detailed studies attribute such collapses to a mix of structural factors, including over-borrowing, massive speculation, and proliferation of toxic assets in portfolios (Schulmerich et al., 2015; Yang, 2017; Bogle, 2012). On the other hand, Shariah-influenced Islamic equities exclude interest-based financial transactions (*riba*), gambling (*maysir*), and investment in ethically prohibited sectors such as alcohol, pork, and traditional banking (Nienhaus, 2011; Rizvi & Arshad, 2018). These features are known to propel comparatively more stable and ethically sifted equity alternatives at times of economic turmoil.

A more alarming issue emerges when the purposes and impacts of the firms themselves are examined. A company may be strictly conforming to all Shariah technical requirements—avoiding debt, interest, and prohibited commodities—yet complicit in actions inherently in violation of Islamic moral ideals. For instance, as highlighted in the Halal Genocide scandal (Saarim, 2025), firms involved in the manufacture of weapons used by occupying or repressive regimes may be technically “halal” investments by screening procedures, yet directly commit injustice; unveils a structural blind spot of Islamic finance: the danger of ethical formalism—adherence to the letter of the law while violating its spirit.

If pursued seriously, this criticism leads to a broad observation: the modern capitalist system—characterized by wealth concentration, war legitimation, environmental degradation, and unregulated consumption—has the potential to stand in inherent contradiction to Islamic values of cooperation, equity, and social justice (Zaman, 2023). Islamic economics in this context is not a minority alternative to capitalism but its normative twin. This forces us to conceptualize Islamic investment, far from being passive investment in foreign markets, as an active instrument to empower the Ummah, to serve the common good, and to gain reward in the Hereafter.

The literature identifies several key factors as drivers of stock market instability:

- **Excessive Leverage:** Financial institutions and investors often rely on borrowed funds to amplify returns. However, high leverage increases the fragility of the financial system, as even minor market fluctuations can trigger widespread deleveraging and systemic collapse (Ho et al., 2013).
- **Speculation:** Market speculation, characterized by short-term, high-risk investment strategies, can inflate asset prices beyond their intrinsic value (Bogle, 2012). This overvaluation often culminates in abrupt market corrections when speculative bubbles burst.
- **Investment in Toxic Financial Assets:** The inclusion of poorly performing or inherently risky financial instruments—often referred to as toxic assets—can undermine the stability of financial portfolios, especially when these assets are highly interconnected within the broader financial system (Baker et al., 2009).

Collectively, these factors contribute to market dynamics that predispose economies to severe downturns during periods of financial stress. In contrast, Islamic finance operates under a distinct set of ethical and legal guidelines that not only shape investment practices but also restrict exposure to various risk factors commonly associated with market volatility. Islamic stocks are distinguished by their adherence to Shariah-compliant investment principles. These principles impose several restrictions on the types of activities and financial practices in which Islamic equities may be involved:

**Ethical and Ratio Screenings:** Ethical screening for Islamic finance screens potential investments according to a set of moral and social criteria derived from Shariah principles. Ratio screenings, by contrast, screen a firm's financial health—its leverage and liquidity, in particular—to ensure that it is not over-indebted. These two screening procedures ensure that the investments are put into corporations not only because they are ethically run (e.g., by not investing in companies such as alcohol, gambling, or pork), but also because they are financially sound in their foundations (Wilson, 1997; Rahman, 2015; Saiti & Noordin, 2018). This lessens risk, promotes corporate responsibility, and aligns investments with social justice and economic fairness values.

**Exclusion of Certain Financial Sectors:** The principles of Islamic finance exclude participation in business sectors that contradict Shariah law. Interest-intensive businesses together with immoral business practices cannot be included in specific Islamic investment portfolios (Obaidullah, 2001; Saiti et al., 2014). By avoiding these industries Islamic finance reduces its overall exposure to high-risk and potentially destabilizing parts of the market. Islamic financial discrimination exists to preserve investors from harmful speculative practices and unethical business activities that build a safer market system.

**Exclusion of Highly Leveraged Firms:** Firms that use a large portion of debt financing are generally more susceptible to economic downturns and to market fluctuations (Derigs & Marzban, 2008; Nienhaus, 2011). The policy of Islam prohibits interest-related transactions so investors refrain from businesses with elevated borrowing needs. Islamic finance constituting financial prudence and stability seeks to avoid placements into businesses that use extensive borrowing. The restriction of investor risk through Islamic finance promotes stable business balance sheets which helps firms choose lower risk measures for sustainable economic terms.

**The Limit of Interest-Based Leverage:** The Islamic finance principles prohibit the use of advance-interest payment loans known as interest-based leverage (Brendan Mulcahy, 2014). Islamically permitted financial gain can only stem from real business revenue and not fixed-interest payments. Implementing profit-and-loss-sharing financing instead of specific returns makes up the core principle of interest-based leverage limitations in Islamic finance (Farooq, 2007). Through risk-sharing mechanics both borrowers and lenders achieve alignment in their investment interests by receiving payment directly from productive economic activities instead of artificial interest payments.

**Exclusion of Complex Structured Financial Products, Derivatives, and Toxic Assets:** Islamic finance restricts its use to straightforward financial products since it refuses to apply derivatives or structured products which remain complicated

and distilled (Masih et al., 2018). The conventional marketplace contains these products that lack tangible association with real-world assets because they operate independently of asset-based economy. Islamic finance stays away from toxic assets therefore it helps maintain market transparency while reducing overall risk in global markets (Karim & Archer, 2013). The nature of Islamic finance investments connects directly to real asset performance so the condition preventing market distortions and financial crisis seen in complex financial products remains strong.

Islamic financial methods eliminate unethical behavior along with creating transparent systems and maintaining stability through fundamental principles (Kayed & Hassan, 2011). Through its focus on risk-sharing combined with asset-backed transactions and rigorous screening procedures Islamic finance system links investments to ethical standards and social values and also reduces the risk exposure involved in unstable conventional financial operations (Awais et al., 2024). The method receives greater support as an economic framework for building sustainable development while safeguarding investors and the economy at large from unnecessary risk exposure. The screens establish an investment pool that may offer reduced vulnerabilities to risk components such as high debt levels and problematic asset exposure that strained stock markets in economic downturns (Askari et al., 2010).

There exists significant divergence between Islamic financial structures and those of conventional markets regarding the oversight system of their monetary financial instruments and organizational framework. Islamic stocks adopt build-in restrictions because conventional markets tend to use high-leverage positions alongside speculative trading activities (Satt & Iatridis, 2024). Such prohibitions of *riba*, *maysir* together with non-qualified financial sector investments creates market stability by inhibiting speculative behavior (Chowdhury, 2015). Research data must prove whether market restrictions create observable effects in terms of reduced price volatility and diminished systemic risks during financial downturns.

An Islamic finance ethical screen when applied to financial portfolios can produce portfolios with distinct compositions compared to conventional indices leading to possible differences in risk profiles. Islamic finance offers an ethical screening approach which presents itself as a complementary solution to current financial market problems stemming from overleveraging and toxic assets specifically during challenging market conditions (Naughton & Naughton, 2000). The limitations of Islamic finance related to interest-based financing ban and unacceptable sectors help reduce specific risks that create market instability. Islamic equities stand out from traditional financial products because of their distinctive features which may help strengthen financial systems.

## **V. CONCLUDING REMARKS AND IMPLICATIONS OF THE STUDY**

Research reveals that Islamic financial instruments possess capacity to establish financial stability in banking operations. Systemic risk reduction happens when Islamic banks forbid securities based on debt and set higher reserve requirements and finance tangible assets instead of mediating financial transactions. Similarly, *sukuk*, with their partnership nature, transform the traditional lender-borrower relationship towards joint risk and mutual participation in project performance.

Moreover, the inherent characteristics of Islamic stocks—such as strict ethical and ratio screens, exclusion of high-leverage firms, and avoidance of complex structured products—render them a relatively stable investment option in times of financial turmoil.

### **5.1. Implications of the Study**

The findings have significant implications for policymakers, financial institutions, and investors:

**For Policymakers and Regulators:** The adoption of higher reserve requirements and limiting debt securitization in Islamic banking activities can contribute to averting the risks associated with excessive leverage at the systemic level. These serve as a blueprint in establishing a more stable financial system that is less susceptible to shocks.

**For Financial Institutions:** Sukuk's structure, which promotes partnerships instead of conventional debtor-creditor relationships, shows a sustainable alternative for risk sharing. The model has the potential to stimulate innovations in Islamic and conventional finance, and hence may have wider applications that mitigate financial fragility.

**For Investors:** The disciplined choice criteria of Islamic stocks offer a portfolio option that inherently does not include poisonous financial assets and dangerous financial dealings. This offers investors a potentially safer option in uncertain market periods and economic downturns.

### **5.2. Limitations of the Study**

Although having promising results, the study has some limitations:

**Empirical Evidence:** Whereas theoretical and initial empirical evidence suggest the benefits of Islamic financial conduct, more systemic and longitudinal evidence is required in order to identify causality from these practices toward reduced financial risk.

**Heterogeneity Across Jurisdictions:** Implementation of principles of Islamic finance varies significantly internationally and across regimes. This diversity may have an impact on external validity of findings and suggests that localized studies shall be required for purposes of exhibiting local contextual fidelity.

**Dynamic Financial Markets:** The global financial environment keeps changing. As such, the efficacy of the existing Islamic financial instruments in offsetting systemic risk can vary in the future and may require continued review and evolving to address the new financial risks.

In sum, though Islamic banking, sukuk, and Islamic stocks are promising avenues toward minimizing systemic financial risks, continued research is warranted to determine the full extent of their long-run effects and further develop these instruments to suit developing market conditions.

### 5.3. Directions for Future Research

**Debt Securitization and Bank Stability:** Empirical research is needed to compare the effect of debt securitization on risk and stability in Islamic versus conventional banks. Future research would need to examine whether the ban on debt trading in Islamic finance lowers systemic risk, according to bank-level risk metrics.

**Reserve Requirements and Bank Performance:** More work is needed on the effect of high reserve requirements on the profitability and behavior of Islamic relative to conventional banks. Research can investigate whether Islamic banks are stronger or more limited with a tight money policy.

**Growth in Financial Assets and Real Sector Influence:** Empirical evidence must look into whether Islamic finance, through its focus on asset-backed products, encourages real sector development better than conventional finance. This can be validated through investment, employment, and output figures at the sectoral level.

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